Minimizing Self-Employment Taxes For LLC Members

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For over twenty years the limited liability company (LLC) has served as the preferred vehicle for owners to set up new business ventures. The primary reasons are that LLC members are afforded strong protection from personal liability and creditor claims compared with classic corporations, and that members may elect from a number of different tax options. Depending on whether appropriate consideration has been given to an LLC's ownership structure, in certain circumstances an LLC may also present members with an opportunity to reduce their overall self-employment tax burdens.

SELF-EMPLOYMENT TAX EXPLAINED

Federal payroll taxes consist of withholdings made on compensation income for Social Security and Medicare. The federal payroll tax burden is divided equally among employers and employees; each is responsible for paying half of the total amount due. However, when an individual is receiving compensation income in a capacity other than as an employee, he or she is considered "self-employed" and is therefore responsible for making both the employer and employee contributions. Although the Social Security portion of federal self-employment taxes is capped annually, contributions for Medicare are not. Together these "self-employment taxes" can add up to a significant marginal tax rate drag on LLC members.

CHOICE OF ENTITY: PARTNERSHIP OR S CORPORATION?

For federal income tax purposes, LLCs may elect to be treated as entities disregarded from their owners, C corporations, or partnerships. Furthermore, an LLC that elects to be treated as a C corporation for tax purposes may make a separate election to be taxed as an S corporation.

C corporations subject earnings to two layers of taxation and for this reason are not considered by most small and medium-sized business owners. Further, the use of a disregarded entity is not possible when an LLC has multiple owners. Consequently, the decision for most multi-member LLCs is whether they want to be treated for tax purposes as a partnership or an S corporation, as both structures are pass-throughs that result in only one layer of taxation.

Maximum flexibility is usually available for LLCs electing to be taxed as partnerships, as the partnership form provides the flexibility to divide income among members using any number of different formulas or methodologies. In contrast, in an LLC that has elected to be taxed as an S corporation, shareholders must always divide income on a strict pro rata basis that tracks the number of outstanding units. S corporations have other disadvantaged tax features as well. For instance, distributions of property in-kind from S corporations result in the recognition of gain, there are additional requirements to avoid gain on contributing property to an S corporation, and investors do not get an immediate tax basis in their investment when they are individually liable for the underlying business's indebtedness. These S corporation rules effectively preclude the use of the election for leveraged real estate investments where investors need debt basis, or private-equity deals where returns are contingent upon meeting certain milestones. Despite these downsides compared with a partnership election, in some cases practitioners will nonetheless recommend that an LLC elect to be treated as an S corporation.

Members of an LLC taxed as an S corporation have easy-to-understand rules for computing – and, in some appropriate cases, reducing – the members' overall self-employment tax liability. In particular, self-employment taxes are imposed only on the amount of income of a member that is attributable to "reasonable compensation." Income earned by the LLC members in an S corporation in excess of the amount of reasonable compensation is not subject to self-employment tax. As discussed further, minimizing the self-employment tax liability of members in an LLC taxed as a partnership can be significantly more complicated.

GENERAL TAX TREATMENT OF LLCS TAXED AS PARTNERSHIPS

When an individual member of an LLC taxed as a partnership performs personal services, self-employment taxes are usually imposed on all of that member's net earnings from the LLC that are not assignable to specific non-compensatory tax items such as rent or interest income. Self-employment tax is always due when an LLC taxed as a partnership makes a "guaranteed payment" to a member, as such payments are considered substitutes for salary. Critically, though, self-employment tax is also due on that member's distributive share of LLC earnings in excess of any guaranteed payments.

The Internal Revenue Code provides some relief from this general rule for certain partnerships, however. In particular, if a partnership is organized as a "limited partnership" under state law, self-employment tax is not due on the LLC's earnings

allocable to limited partners. Whether this exception for limited partnerships is applicable to LLCs has been a point of controversy.

Strictly speaking, an LLC member is not the same thing as a state-law limited partner, even though both usually are afforded limited liability and are treated as partners under the Internal Revenue Code. For example, one core difference is that LLC members may have managerial powers, whereas normally a limited partner would not. As such, the application of the limited partner self-employment tax exception to LLCs has remained somewhat unclear. Naturally, however, since the Department of Treasury provided back in 1997 that LLCs may elect to be treated as partnerships for federal tax purposes, practitioners have wanted to know whether and how the limited partner exception applies to LLC members.

THE PROPOSED REGULATIONS

Treasury attempted to provide a road map for determining whether LLC members are considered limited partners for self-employment tax purposes in 1997 when it issued a set of Proposed Regulations (the "Proposed Regs."). These Proposed Regs. apply only to LLCs treated as partnerships, and do not impact the self-employment tax rules for S corporations discussed earlier.

After the Proposed Regs. were released, Congress raised various concerns and imposed a one-year moratorium blocking their finalization. After the expiration of the moratorium, the Proposed Regs. were never finalized and are not legally binding on taxpayers. Despite these setbacks, the IRS has since consistently provided in guidance to practitioners that they may informally rely on the Proposed Regs. in determining whether an LLC member's income is subject to self-employment tax.

The main feature of the Proposed Regs. is that a three-part test is used to determine whether an LLC member is "functionally" a limited partner for self-employment tax purposes (the "functional limited partner test"). Under the Proposed Regs., there is a presumption that a member is akin to a limited partner not subject to self-employment tax on his or her distributive share of LLC earnings, unless that member fails the functional limited partner test. Under the Proposed Regs., an individual is by default treated as a functional limited partner unless:

1. The individual has personal liability for the debts of the LLC by virtue of his membership interest;
2. The individual has authority under local law to contract on behalf of the LLC; or
3. The individual participates in the LLC's trade or business for more than 500 hours during the LLC's taxable year.

LLCs are either member-managed or manager-managed. The type of LLC management is critical in determining whether a member's distributive share is subject to self-employment tax. No member of a member-managed LLC can be treated as a limited partner, because in this structure each member has statutory authority to bind the LLC in contracts entered into with third parties. In contrast, in a manager-managed LLC, the power to bind the entity is vested in a manager or group of managers.[1] As such, manager-managed LLCs offer opportunities to potentially categorize some portion of the distributive share of members as exempt from self-employment tax. The Proposed Regs. contain no analysis of how voting or non-voting interests may alter this analysis.

One of the primary limitations on the functional limited partner test is that it is not applicable when members are performing substantial services for an LLC that is in a trade or business considered to be a "service partnership." When members are performing substantial services for a designated service partnership, the Proposed Regs. provide that the members cannot be considered limited partners under any circumstances. The definition of a service partnership for purposes of this analysis is technical; it covers a common but definitionally narrow group of classic professions. This limitation is discussed further below.

FUNCTIONAL LIMITED PARTNER TEST, RELAXATION

If a member fails the functional limited partner test, under certain conditions two relaxation rules may allow the member, for self-employment tax purposes, to treat all or a portion of his or her distributive share as if it were attributable to a limited partnership interest. These two relaxation rules are commonly referred to as the "Multiple Class Exception" and the "Material Participation Exception." The relaxation rules are as follows:

1. The Multiple Class Exception. A member who fails the functional limited partner test may still be treated as a limited partner with respect to a portion of his or her interests in circumstances where the member owns multiple classes of interests, and a portion of those interests are the same as interests held by functional limited partners. The Multiple Class Exception essentially bifurcates a member's interests into a general partnership interest and limited partnership interest, the latter class of ownership being exempt from self-employment tax. This exception is applicable when (a) the LLC has other members who meet the functional limited partner test and who own a substantial, continuing interest in the same class of interest that is held by the member and (b) the member's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of the specific class of interest that the functional limited partners hold. The Proposed Regs.

1 The Proposed Regs. essentially equate an LLC's manager with the general partner of a limited partnership. Both are similar in the sense that they have centralized managerial authority over the entity, but unlike a general partner, an LLC manager need not be a member under state law.

explain that an interest under this provision is considered "substantial" based on an analysis of all available facts and circumstances. A safe harbor in the Proposed Regs. further provides that an ownership of 20% of one class of interest is automatically considered "substantial." The preamble to the Proposed Regs. expressly states the purpose of this relaxation rule is to separate the portion of a member's return that may be attributed to a capital investment from the portion attributable to the performance of services.

2. The Material Participation Exception. The Material Participation Exception applies to instances where a member holds only one class of membership interest in an LLC, and it applies only when a member fails the functional limited partner test solely because he or she participates in the LLC's business for more than 500 hours during a given year. Under these circumstances, a member is still deemed to be a functional limited partner if immediately after receiving his or her interest in the LLC (a) there are other members who satisfy the functional limited partner test in the LLC; (b) the other functional limited partners own a substantial, continuing interest in the LLC of the same class of interest as the member; and (c) the member who is contributing more than 500 hours of services has rights and obligations in his or her class of interest that are identical to the rights and obligations of the specific class of interest held by the functional limited partners. The primary take-away from this exception is that a member who is over the hours threshold but owns only a membership interest essentially identical to those owned by functional limited partners cannot really be said to be a general partner. The rationale for this rule is clear: If a member is performing substantial services to an LLC but has no management authority and receives from his or her equity class exactly the same amount of distributive earnings as completely passive members who are performing minimal services, his or her earnings from that class of LLC equity cannot be said to be attributable to personal services and should not be subject to self-employment tax.[2] One clear flaw in this particular relaxation rule, however, is that it presumes there is an individual member on some level who is not a limited partner, or an alternate class of equity that is not clearly limited. As noted earlier, this assumption is not necessarily accurate with respect to an LLC.

An important feature of both the functional limited partner test and the two relaxation rules is that ultimately an LLC must have at least one member who is able to bind the entity contractually with third parties, and that the distributive share of this person's interest is primarily subject to self-employment tax. But to the extent a portion of this person's interest in the LLC is the same as that of other true limited partners, then this portion is not subject to self-employment tax.

LIMITATION FOR SERVICE PARTNERSHIPS

As noted earlier, the Proposed Regs. provide a global limitation that restricts the use of the functional limited partner test where a member is performing substantial services to an LLC that is considered a "service partnership." A service partnership is an entity where substantially all the income-producing activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. A member of an LLC who is performing more than a *de minimis* amount of those services for a service partnership is per se not a limited partner, regardless of whether he or she would meet the functional limited partner test or would qualify for relief under the relaxation rules. Presumably this limitation is in place because these sorts of classic professional service businesses cannot realistically have truly passive investors for regulatory purposes.

SUBSEQUENT DEVELOPMENTS

Since 1997, the IRS has dealt with a number of cases concerning the application of self-employment tax to limited partnerships and LLCs. But because the Proposed Regs. were never finalized, reviewing authorities have had to rely on a more nuanced statutory analysis in analyzing individual cases.

In *Renkemeyer, Campbell, and Weaver, LLP v. Comm'r*, the Tax Court rejected the contention made by partners of a law firm that a portion of their distributive income was not subject to self-employment tax. In *Renkemeyer*, the law firm was organized as a limited liability partnership, and comprised two classes of ownership: a "general managing unit" class and a nominally passive "investing partnership unit" class. The Tax Court indicated that under state law, all the partners had management authority under the LLP statute and therefore could not be considered limited partners. The Tax Court also noted that all three of the partners were performing significant services for the LLP in their capacity as such. The *Renkemeyer* case is very similar to *Castigliola v. Comm'r*, where the members of the professional limited liability company and law firm attempted to claim amounts in excess of set guaranteed payments were not subject to self-employment tax. The Tax Court reached the same conclusion in *Castigliola* as it did in *Renkemeyer*: The members were not analogous to limited partners because under state law they retained managerial control over the entity.

In *Riether v. United States*, the members of an LLC consisted of a husband and wife who paid themselves a W-2 salary and claimed the excess distributive earnings were not subject to self-employment tax. The district court rejected this argument at the outset, as under the controlling law – found in Rev. Rul. 69-184 – the W-2 allocations were in error because, for income tax purposes, partners may not be considered employees. The district court indicated that the husband and wife could not be

2 The member in this situation may want to receive a guaranteed payment for his or her 500 hours of services, however.

limited partners in the LLC because their management powers precluded limited partner status.

IRS Chief Counsel Memoranda issued in 2014 and 2016 echo the sentiment of reviewing courts on the subject of self-employment taxes for LLCs. Specifically, the control and participation of members appear to be a superfactors that will override any characterization by those same members that their distributive earnings are not subject to self-employment tax. Notably, the IRS's guidance also seems to reject the premise that the statutory exception for limited partners is designed to provide for self-employment tax relief on earnings attributable to a member's capital investment, something the Proposed Regs. expressly state they are trying to approximate. Despite this statement, there is no indication that the IRS has abandoned its position of not challenging taxpayers who manage their affairs consistent with the Proposed Regs.

What is clear from *Renkemeyer, Reither*, and the other cases is that the Proposed Regs. would have clearly foreclosed the taxpayers from claiming that their earnings were not subject to self-employment tax. This is because all the relevant individuals in those cases clearly had managerial authority over the entity, were performing substantial services, and/or were participating as members of a "service partnership." As such, the most important aspect of applying the Proposed Regs. to newly formed LLCs is likely to be whether the purported limited partners are, in fact, acting in whole or in part in a capacity consistent with such.

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